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Inflationary wave theory

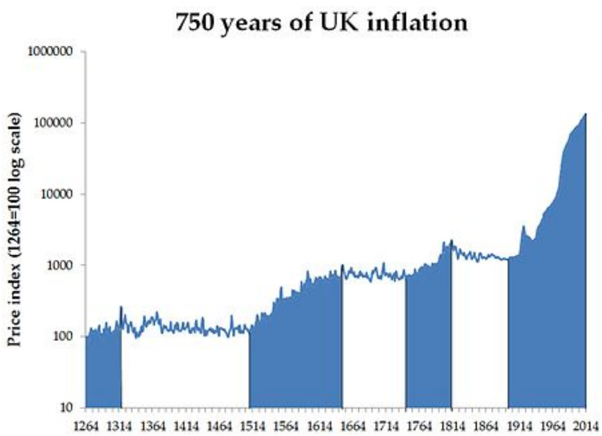
Inflationary wave theory is an economic concept proposing that over time prices follow a wave-like pattern.[1] There are periods of rising inflation which often last for over a century which are followed by periods of equilibrium with more stable prices or mild deflation, before the cycle repeats itself. The length of the waves, the intensity of the inflation and its causes all vary, but the broad periodicity remains.

Contents

History of the theory

The theory was first proposed by finance author Pete Comley in his 2015 book *Inflationary Matters*.[2] However his analysis was influenced by the historian David Hackett Fischer's 1996 book *The Great Wave: Price Revolutions and the Rhythm of History*.[3] Both were fascinated by the history of price inflation and how it appeared to follow waves and how these were synchronised across many countries – even in medieval times. Fisher provides evidence for these waves in Roman times and Comley clearly demonstrates them in UK prices since 1250 (see graph based on data compiled by Henry Phelps-Brown and Sheila Hopkins[4])

Causes of inflationary waves

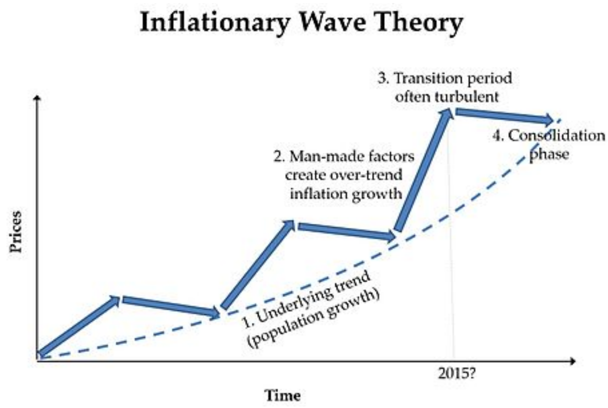


750 years of UK price inflation based on Phelps-Brown, H. and Hopkins, S., 1956 and ONS data

Inflationary Wave Theory proposes that there is an underlying factor that is driving prices higher over time. This is caused by the interplay of demographics/population growth and their competition for resources – a Malthusian concept. However like many financial trends it follows a wave-like pattern as prices often get too far ahead of the trend and have to consolidate or there is major change in demand (e.g. caused by declining populations).

A new wave starts once investors spot that prices have broken out of the consolidation phase, they seek investments that will hold their value in the coming inflation. The key asset is land and housing, but shares are also bought. Investors take out loans to buy them, as they know the true value of these debts will be eroded. This process increases the money supply and so creates a

value of these debts will be eroded. This process increases the money supply and so creates a general increase in prices. An inflationary mindset sets in. This feeds a vicious cycle, as more people want to exploit the inflation and seek higher pay rises and also feed the money supply. Governments also encourage the inflation as it allows them to overspend knowing that inflation will eventually reduce the value of their deficits and accumulated debts.[5]



Graphical summary of Inflationary Wave Theory

There comes a point when prices get too far above the underlying trend, or demographics alter the underlying demand. Prices then typically suffer a deflationary shock where they decline a half over a period of around 5 years. Although prices then recover, they never get above their previous highs. Over the following 80–100 years prices gradually trend downwards as productivity and technological improvements reduce costs.

The theory is not inconsistent with monetarist theories of inflation. Indeed Comley shows that the bulk of the rises seen in the inflationary phase are directly related to excess expansion of the money supply.[6]

Current state of cycle

In 2015, the UK was 115 years into its latest inflationary phase. Historically, they have lasted between 85–140 years and so the pivot point could well happen in the coming couple of decades. There are already many deflationary forces exerting themselves from lower commodity prices to competitive devaluations. In addition, populations are ageing fast in the developing world and with them spending. Add to that overall declining birth rates and it is clear that the underlying demand curve is shifting downwards.

However Comley proposes[7] that fully switch into a deflationary world, some conditions need probably need to be complied with to ensure that inflation does not take off again. World debts need to be made more sustainable either through default or restructuring and excess money creation over the last few decades needs to be resolved. That can either be by prices rising substantially or more likely by reductions in the money supply. Although it is impossible to predict what circumstances might comply with these conditions and when, Comley believes it is likely to be some form of major financial crisis – probably centred on sovereign debt. The chain of events triggered by this would ensure the remaining debts became more sustainable and the accompanying wealth destruction would resolve the latent inflation issue.

References

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